

***United States Court of Appeals  
for the Second Circuit***



**APPELLEE'S BRIEF**



# 75-4123 & 75-4201

**United States Court of Appeals**  
FOR THE SECOND CIRCUIT

No. 75-4123

IRWIN C. GUILD AND BERNICE GUILD,  
*Appellants-Cross-Appellees,*  
*v.*

COMMISSIONER OF INTERNAL REVENUE,  
*Appellee-Cross-Appellant.*

No. 75-4201

JONATHAN LOGAN, INC.,  
*v.* *Appellee,*

COMMISSIONER OF INTERNAL REVENUE,  
*Appellant.*

ON APPEALS FROM THE DECISIONS OF THE  
UNITED STATES TAX COURT

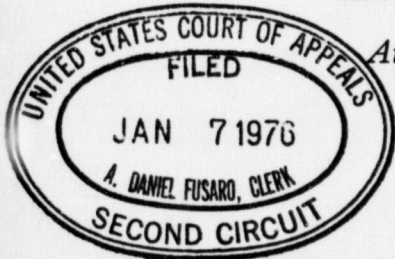
**BRIEF FOR APPELLEE, JONATHAN LOGAN, INC.**

KRONISH, LIEB, SHAINSWIT, WEINER &  
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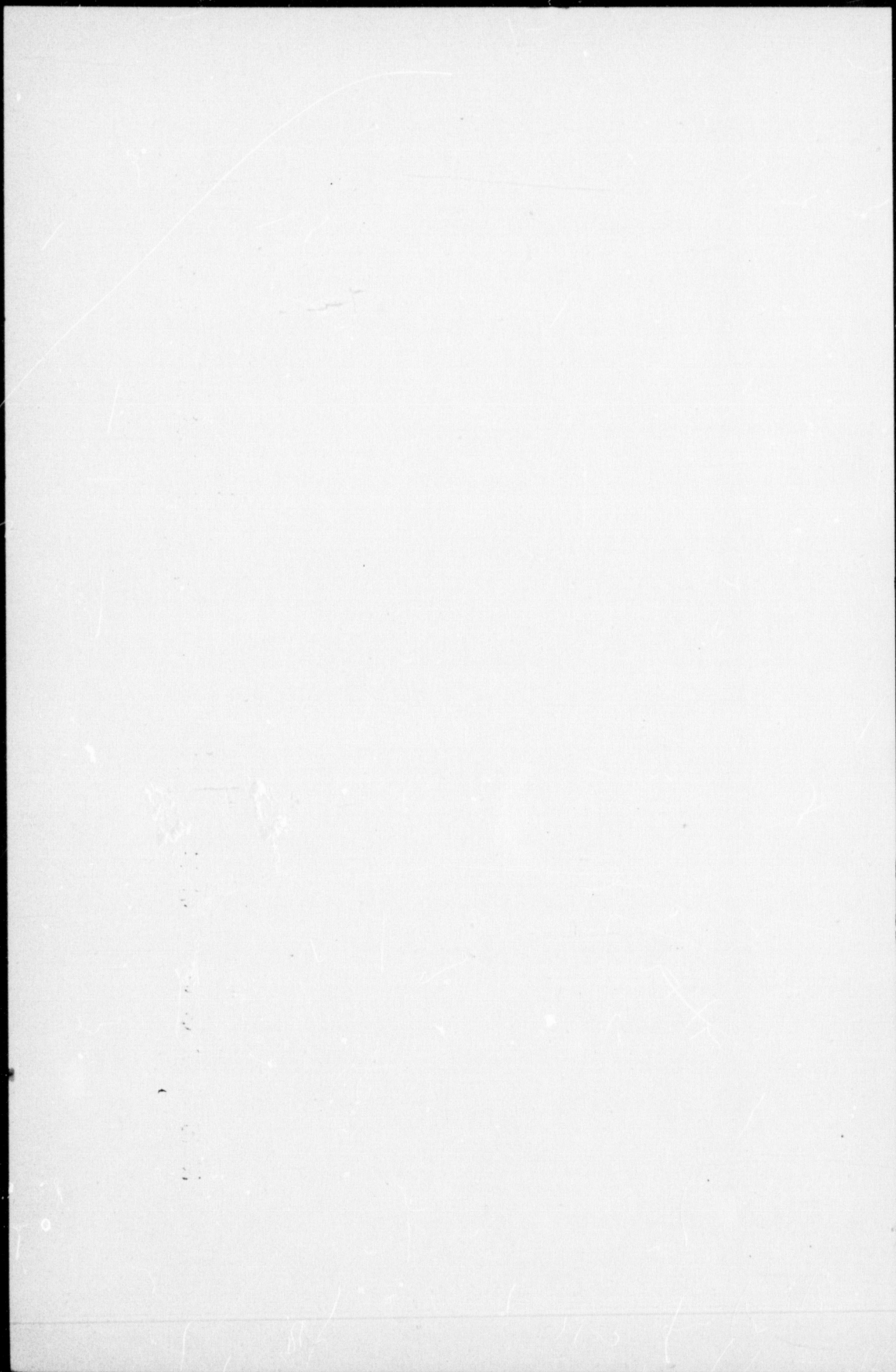
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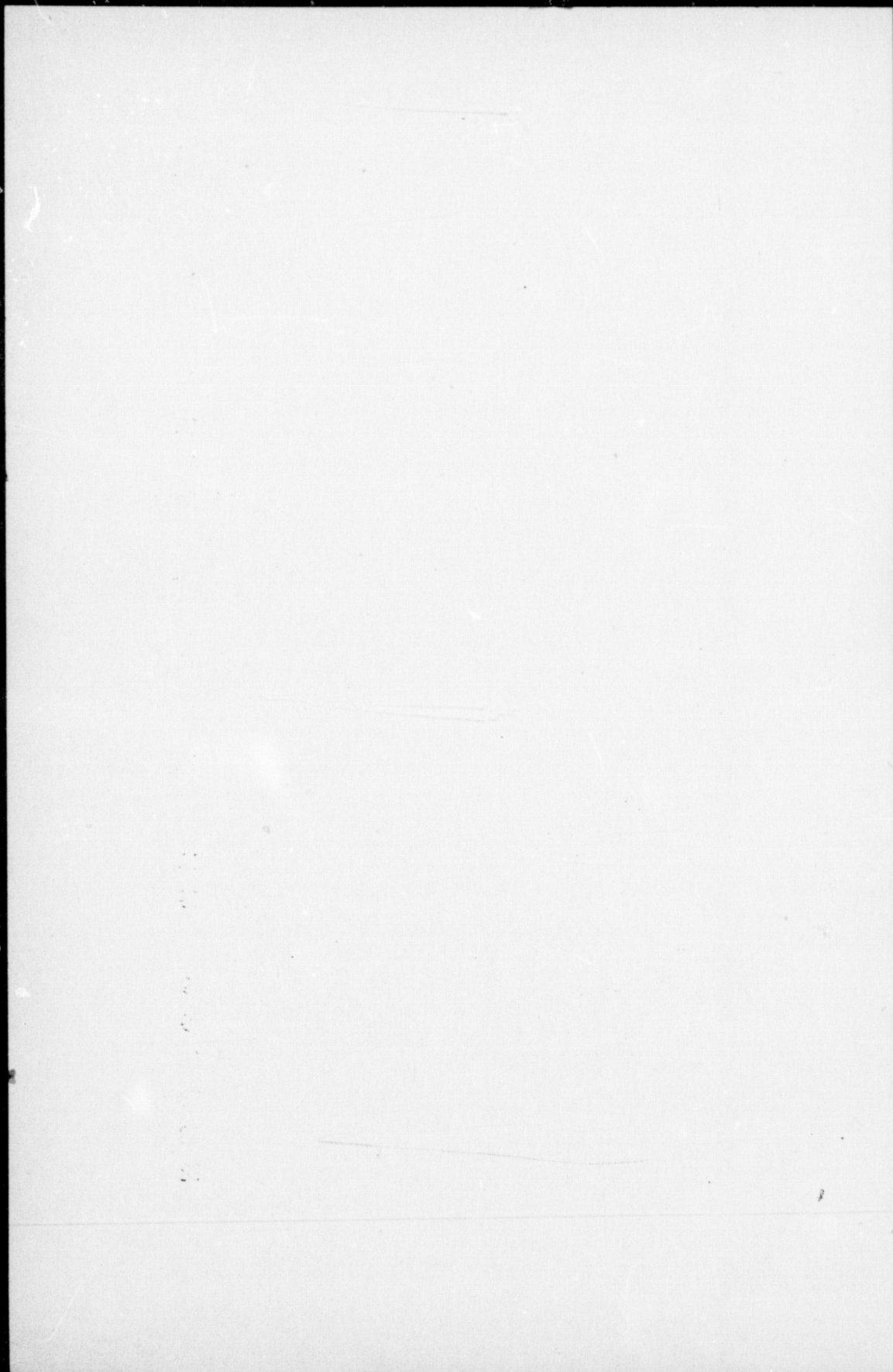
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ON APPEALS FROM THE DECISIONS OF THE  
UNITED STATES TAX COURT

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## BRIEF FOR APPELLEE, JONATHAN LOGAN, INC.

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### STATEMENT OF THE ISSUES PRESENTED

1. Whether the Tax Court correctly held that Logan was entitled to a trade or business deduction upon the transfer of its stock to Guild in settlement of a lawsuit and

that the transfer of such stock was not pursuant to the exercise of a restricted stock option under Sections 421 and 424 of the Internal Revenue Code of 1954.

2. Whether the Tax Court abused its discretion in denying Guild's attempts to raise the issue of the value of the stock he received when such issue was raised for the first time after the Tax Court had entered its Findings of Fact and Opinion in this case.

### STATUTES INVOLVED

The statutes involved in this action are Sections 61, 162(a), 421(a), (b), 424 and 425(h) of the Internal Revenue Code of 1954, 26 USC, Subtitle A, Chapter 1.<sup>1</sup> These statutes are set forth in an addendum hereto.

### STATEMENT OF THE CASE

On November 20, 1967 Jonathan Logan, Inc. ("Logan") sold 6,500 shares of Logan stock to Irwin C. Guild ("Guild") for \$15.46 per share (R. 61a)<sup>2</sup>.

On August 10, 1972 the Commissioner asserted a deficiency against Guild<sup>3</sup> determining that Guild realized ordinary taxable income in the amount of \$253,760, the difference between the fair market value of those 6,500 shares of Logan stock and the amount he paid for the shares (R. 23a-26a).

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<sup>1</sup>Unless otherwise denominated, subsequent references to Code Sections will be to the Internal Revenue Code of 1954, as amended, 26 USC, Subtitle A, Chapter 1.

<sup>2</sup>In accord with Rule 30, "R" references are to the pages of the separately bound joint appendix. All other references will be made to the original paging of each part of the record.

<sup>3</sup>References to Guild are to Irwin C. Guild. Bernice Guild is a party to this case because she filed a joint return with her husband for the year in issue.

On August 10, 1972 the Commissioner asserted a deficiency against Logan determining that the amount of \$253,760 claimed as a deduction in connection with Logan's sale of 6,500 shares of its stock to Guild was not a deductible expense (R. 30a-31a).

A timely petition was filed by Guild (R. 18a-22a) on November 6, 1972, and was duly answered. A timely petition was filed by Logan (R. 30a-39a) on November 3, 1972 and was duly answered. On November 16, 1973, pursuant to an oral motion, the cases were consolidated and tried. On September 16, 1974 the Tax Court set forth its Findings of Fact and Opinion holding that the sale of stock resulted in taxable income to Guild and a trade or business deduction to Logan (R. 43a-54a). On May 1, 1975, the Tax Court entered its decision in *Irwin C. Guild and Bernice Guild v. Commissioner*, No. 75-4123, Tax Court Docket No. 8284-73 ("*Guild*") determining a deficiency in Guild's income tax liability for the year 1967 in the amount of \$137,662.26 (R. 55a). On May 1, 1975 the Tax Court also entered its decision in *Jonathan Logan, Inc., v. Commissioner*, No. 75-4201, Tax Court Docket No. 8218-72 ("*Logan*") determining a deficiency in Logan's income tax liability for the year 1967 on an unrelated, previously settled, matter (R. 56a).

Guild filed a timely notice of appeal on June 9, 1975 (R. 1a). The Commissioner filed a timely notice of appeal in *Guild* on June 24, 1975 (R. 2a). The Commissioner filed a timely notice of appeal to this Court in *Logan* on June 23, 1975 (R. 3a).<sup>4</sup> The parties have executed and

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<sup>4</sup>Statutory venue in *Logan* lay to the Third Circuit. Pursuant to Section 7482(b)(2) of the Code, the parties in *Logan* have stipulated to venue in this Court (R. 4a). The notice of appeal to the Third Circuit filed by the Commissioner on June 16, 1975 in *Logan* was dismissed on August 14, 1975 (R. 14a).

filed a stipulation to consolidate these appeals which has been approved by this Court (R. 5a-7a). Jurisdiction is conferred upon this Court by Section 7482 of the Code.

### STATEMENT OF FACTS

The relevant facts of this case as found by the Tax Court are as follows:

Guild entered into an employment agreement with Logan on September 24, 1963. This agreement provided for Guild's employment as an executive sales manager of a Logan division until December 31, 1965. Pursuant to the employment agreement, Guild was to receive a \$30,000 salary and a \$25,000 expense allowance per year. In addition, in a separate agreement, Guild was granted an option to purchase 25,000 shares of Logan common stock at \$15.46 per share. The entire option was not exercisable at one time. It was broken into four separate exercise periods as follows (R. 45a):

On or after September 24, 1964—10,000 shares;

On or after April 1, 1965—5,000 shares;

On or after April 1, 1966—5,000 shares;

On or after April 1, 1967—5,000 shares.

In addition to staggered exercise dates, the option was subject to specific conditions set forth in paragraphs 4, 5 and 6 of the option agreement.

Paragraph 4 required that Guild be employed by the Company or a subsidiary at the time of any given exercise of the option (R. 67a). Paragraph 5 provided that, in the event of the termination of Guild's employment with Logan, Guild's right to purchase stock, pursuant to the option, would cease "for all purposes" unless such termination occurred during an exercise period. If the termi-

nation occurred during an exercise period, Guild could purchase stock pursuant to the option (to the extent to which the option was exercisable at the time of the termination) for a period of three months from the date of termination. Notwithstanding such rights, however, if Guild's employment was terminated "for cause" all of his rights under the option agreement would expire immediately upon termination (R. 46a).<sup>5</sup>

Paragraph 6 of the option agreement set forth the manner in which the option was to be exercised. The prescribed manner of exercise was for Guild to provide written notice to Logan at Logan's principal office in North Bergen, New Jersey of his election to exercise the option specifying the number of shares to be purchased, accompanied by payment in cash, certified check or cashier's check, of the purchase price for the number of shares being purchased (R. 46a).<sup>6</sup>

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<sup>5</sup>Paragraph 5 of the option agreement provided as follows (R. 46a): "*Termination of Employment and Death*: If your employment by the Company or subsidiary terminates, this option shall cease for all purposes, except that if such termination shall occur during the Exercise Period, this option may thereafter be exercised (to the extent to which it was exercisable at the time of such termination) during a period of three (3) months from the date of such termination, but not, in any event, later than the Expiration Date; provided that if during the Exercise Period (i) your employment is terminated by death or (ii) your employment terminates and death occurs within three (3) months thereafter, this option may thereafter be exercised (to the extent to which it was exercisable at the time of your death) during a period of six (6) months after your death, but not, in any event, later than the Expiration Date. Notwithstanding the foregoing provisions, if your employment is terminated for cause, all of your rights hereunder shall expire immediately upon such termination."

<sup>6</sup>Paragraph 6 of the option agreement provides as follows (R. 46a): "*Manner of Exercise*: Should you desire to exercise your option to purchase any of the shares which at the time you are entitled to purchase hereunder, you shall give *written notice* of such election to the Company at its principal office in North Bergen, N. J., specifying the number of shares to be purchased, *which notice shall be accompanied by payment to the Company in cash (or certified*

The term of the employment agreement executed by Logan and Guild was for two years and four months, running from September 1, 1963 to December 31, 1965 (R. 64a). The option agreement was for five years and expired on September 24, 1968 (R. 67a). Logan and Guild expressly recognized that the option agreement extended beyond the term of the employment agreement. Guild acknowledged, in the employment agreement, that the longer option period was not intended to grant him any employment rights beyond those set forth in the employment agreement (R. 64a-65a).

Guild exercised his rights to purchase the 10,000 shares subject to option during the first exercise period in October, 1964. Guild's employment was terminated by Logan on November 10, 1964. The following day, in a conversation with Logan's President, Guild requested that he be given what he considered due him under his employment agreement, including the right to purchase the remaining 15,000 shares subject to the option. He was told that the matter would have to be litigated (R. 47a).

Guild filed suit against Logan on January 15, 1965 in the United States District Court for the Southern District of New York. This suit was dismissed without prejudice. A new suit was instituted in the New York State courts (R. 47a). In both of these actions Guild alleged that he

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*or bank cashier's check) of the purchase price for the number of shares being purchased. At the same time, you shall represent and agree with the Company in writing that you are acquiring the shares for investment purposes. The Company shall not be obligated to deliver any shares until they have been listed upon each Stock Exchange upon which outstanding shares of common stock at the time are listed, and not until there has been compliance with such laws and regulations as the Company may deem applicable. No fractional shares shall be delivered hereunder. Before issuing any shares upon exercise, the Company may require you to furnish a written representation that you are acquiring the shares for investment and not for distribution" [emphasis added by the Tax Court].*

sustained the following damages due to Logan's alleged breach of the employment agreement:

- a) Salary ..... \$62,639.00
- b) Cash Expense Allowance .. 3,410.00
- c) Automobile ..... 4,100.00
- d) Credit card (personal use) 2,733.00
- e) Trips abroad ..... 6,000.00
- f) Health insurance ..... 251.84
- g) Deprivation of the right to  
purchase the remaining  
15,000 shares of stock  
covered by said option

Ir both the federal action and state action Guild sought alternative damages with respect to his alleged deprivation of the right to purchase 15,000 shares of Logan stock. Guild sought either the right to purchase the stock at the option price or \$375,000 which he claimed represented the value of the unexercised portion of the option. In addition, he sought money damages for the above itemized claims (R. 75a-76a; R. 81a-82a).

Guild's action against Logan was settled on November 20, 1967 when Guild purchased 6,500 shares of Logan stock for \$15.46 per share, a total of \$100,490, which stock had a then market value of \$54.50 per share, or a total market value of \$354,250. This settlement was in satisfaction of all of the claims Guild had asserted against Logan (R. 48a). The settlement was evidenced by four documents: (1) a Stipulation of Discontinuance filed in the New York Supreme Court; (2) a release executed by Irwin Guild, releasing Logan, its Chairman and its President from all claims of every kind and nature Guild had against them,

(3) a release executed by Logan, releasing Guild from all claims it had against him, and (4) a transmittal letter from Logan's President to Guild acknowledging Guild's contemporaneous purchase of 6,500 shares of Logan stock (R. 89a-92a).

On his 1967 federal income tax return Guild reported no income in connection with his bargain purchase of Logan stock (Stip. Ex. 1-A). Upon audit the Commissioner determined that Guild realized ordinary income from that purchase in the amount of the difference between the fair market value of the stock and the amount Guild had paid for it, or \$253,760 (R. 26a).

On its 1967 federal income tax return Logan deducted as an ordinary and necessary business expense the difference between the fair market value of the stock it sold to Guild and the amount Guild had paid for it. Upon audit, the Commissioner determined that Guild had purchased the Logan stock pursuant to the exercise of a restricted stock option which rendered the bargain element in that purchase nondeductible by Logan. A deficiency in Logan's federal income tax liability for the year 1967 was determined accordingly (R. 30a-32a). The determination with respect to Logan, which was admittedly inconsistent with that taken with respect to Guild, was taken in order to avoid having two taxpayers successfully take inconsistent tax positions with respect to the same transaction (Comm. Br. p. 8).

The Tax Court held that Guild's purchase of Logan's stock was not pursuant to the exercise of a restricted stock option under Section 424 of the Code. Consequently, Guild was required to recognize income and Logan was permitted to take a deduction with respect to the bargain element of that transaction (R. 52a).

## ARGUMENT

### POINT I

**LOGAN INCURRED AN ORDINARY AND NECESSARY BUSINESS EXPENSE AND GUILD REALIZED ORDINARY TAXABLE INCOME UPON HIS BARGAIN PURCHASE OF LOGAN STOCK.**

**A. Logan is Entitled to a Deduction Pursuant to Section 162 of the Code.**

In the context of this transaction, Sections 61 and 162 of the Code provide substantial symmetry. From Logan's side of the transaction, Section 162(a) of the Code provides, in part, "There shall be allowed as a deduction all of the ordinary and necessary business expenses paid or incurred during the taxable year in carrying on any trade or business, . . .". From Guild's side, Section 61 of the Code defines gross income as " . . . all income from whatever source derived, including . . . Compensation for services . . .". Treasury Regulations Section 1.61-2(d) and 1.162-9<sup>7</sup> recognize that compensation frequently takes the form of property other than money, and in such cases the Regulations provide that the amount of the income, and the correlative deduction, is the fair market value of the property received less any amount paid for the property<sup>8</sup>.

It has long been held that the bargain purchase by an employee of his employer corporation's stock results in realization to the employee of ordinary taxable income to the extent of the bargain element in such transaction. *Commissioner v. LoBue*, 351 U. S. 243 (1956); *Commissioner v. Smith*, 324 U. S. 177 (1945). It also has long been held that amounts paid to employees by employers to terminate

<sup>7</sup>Treasury Regulations Sections 1.61-2(d) and 1.162-9 are set forth in the addendum hereto.

<sup>8</sup>In the context of compensatory stock sales to an employee, Section 421 of the Code creates the only relevant exception to the rules of Sections 61 and 162 of the Code.

employment contracts, or settle disputes arising out of employment contracts, are includible as ordinary income by the employees and deductible by the employers. *Knuckles v. Commissioner*, 349 F. 2d 610 (10th Cir. 1965), *aff'g* T. C. Memo 1964-033 (1964); *Metropolitan Company v. U. S.*, 176 F. Supp. 195 (S. D. Ohio 1959); *Leo Dalbo v. Commissioner*, T. C. Memo 1969-220 (1969); *Boulevard Frocks, Inc. v. Commissioner*, T. C. Memo 1943-007 (1943).

*Knuckles* is similar in many respects to the instant case. In *Knuckles*, the taxpayer was fired by his employer prior to the termination of his employment contract. The taxpayer engaged counsel who commenced suit against the employer for breach of that contract. The suit was settled and the Commissioner asserted that the sum received in settlement was ordinary income. The taxpayer countered that the amounts received were excludible under Section 104 of the Code as compensation for damages to the taxpayer's health and personal reputation. The Tax Court rejected the taxpayer's argument primarily because he was unable to prove that personal injuries were his only damages. The Court of Appeals, recognizing the factual nature of the issue, affirmed.

The Tax Court, in the instant case, found in its Opinion that "Logan used the medium of a stock sale at a bargain price to compensate Guild for damages arising out of the alleged breach of his entire employment agreement of which the stock option was a part. The Logan stock was transferred to Guild pursuant to the compromise settlement of a lawsuit not pursuant to the exercise of a restricted stock option plan" (R. 50a). Based upon the evidence presented to the Tax Court, these conclusions were not "clearly erroneous".

This Court has often stated in the context of appeals from the United States Tax Court that it is bound by Rule

52(a) of the Federal Rules of Civil Procedure requiring the lower court's findings of fact to be upheld unless they are clearly erroneous. *Lamont v. Commissioner*, 339 F. 2d 377 (2nd Cir. 1964), *aff'g* T. C. Memo 1964-002; *Austin v. Commissioner*, 298 F. 2d 583 (2nd Cir. 1962), *aff'g* 35 T. C. 221 (1960). The clearly erroneous rule applies equally to reasonable inferences drawn from the undisputed evidentiary facts. *Commissioner v. Duberstein*, 363 U. S. 278 (1960). Since the Tax Court in the instant case found that Logan sold its stock to Guild at a bargain price to compensate Guild for damages arising out of an employment agreement and since the substantive law is beyond dispute, the Tax Court must be affirmed unless this Court determines that such a finding was clearly erroneous.

**B. Guild's Bargain Purchase of Logan Stock Did Not Constitute the Exercise of a Restricted Stock Option.**

Sections 421 through 425 of the Code create a narrow exception to the general rules set forth in Sections 61 and 162 of the Code. Section 421(a) of the Code provides in pertinent part that, upon the transfer of stock pursuant to the exercise of a restricted stock option which meets the requirements of Section 424 of the Code, the employer corporation does not receive a deduction and no income is realized by the employee recipient. In order for the employee recipient of a bargain sale of stock to receive this preferential tax treatment, the option and its exercise must comply with the following provisions, *inter alia*, of Section 424(a) of the Code:<sup>9</sup> (1) the transfer of the stock must be pursuant to the "exercise" of a restricted stock option;

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<sup>9</sup>The option involved in this case was granted in September 1963 and is subject to the provisions applicable to restricted stock options rather than the provisions of Section 422 of the Code applicable to qualified stock options. Since the options were granted to Guild prior to December 31, 1963 they were originally governed by the rules set forth in Section 421 of the Code prior to its amendment by Section 221(a) of the Revenue Act of 1964, P. L. 88-272, 78 Stat. 19.

(2) the optionee must exercise the option while he is an employee of the corporation or within three months after he ceases to be an employee; and (3) no disposition of such shares may be made by the optionee within six months after the transfer to him.

No question is raised in this appeal as to whether the option granted by Logan at the time of Guild's employment constituted a restricted stock option within the meaning of the forerunner to Section 424 of the Code.<sup>10</sup> The question Guild raises in his brief (Guild Br. pgs. 14-30) is whether Guild's bargain purchase of Logan stock in 1967, approximately three years after he was fired by Logan and in settlement of a lawsuit against Logan, can qualify as the exercise of a restricted stock option.

Paragraph 4 of the option agreement required that Guild be employed by the Company at the time of any given exercise (R. 67a). Guild does not argue that he was so employed. Paragraph 5 of the option agreement provided that all of Guild's rights under that agreement would cease "for all purposes" upon the termination of his employment unless such termination occurred during an exercise period (R. 46a). When Guild was fired by Logan he had already exercised the only portion of the option which was available to him as of that date. No further option rights would accrue under the agreement until April 1, 1965, approximately five months after the date his employment was terminated (R. 49a). Guild's actual purchase of the Logan stock on November 20, 1967 took place more than three years after his employment was terminated (R. 48a).

Guild initially argues (Guild Br. pgs. 14-25) (i) that Logan terminated his employment without cause and thereby breached its agreement, (ii) that all of the options

<sup>10</sup>Prior to the amendments made by Section 221(a) of the Revenue Act of 1964, P. L. 88-272, 78 Stat. 19, the former Section 421 of the Code contained many of the rules presently found in Sections 421, 424 and 425 of the Code. The option granted to Guild was governed by Section 421 of the Code as it existed prior to December 31, 1963.

became immediately exercisable and that he properly exercised the options on November 11, 1964 when he orally demanded his rights from Logan's President, and (iii) that New York law would specifically enforce his rights under the option agreement and that Logan admitted as much in its settlement letter. The simple answer to each of these arguments is that they are not supported by either the facts or the law.

The Tax Court, in rendering its opinion, stated: "Accordingly, we conclude that the requirements of Section 424(a) were not met because no option was available to Guild within the three-month period following his discharge" (R. 50a). The Tax Court found "... that Guild failed to exercise it [an option] in the manner prescribed in Section 1.421-1(e), Income Tax Regs." (R. 50a). The Tax Court found that Guild did not comply with the terms of the Logan option and that Guild's conversation with Logan's President did not constitute the exercise of a restricted stock option. The Court found that Guild "... did not become obligated to buy Logan stock until final settlement of the lawsuit in 1967." (R. 51a-52a) Finally, the Tax Court found that Guild failed to establish that he had been wrongfully discharged by Logan or that the settlement of his suit against Logan constituted an acceleration of the option (R. 52a). All of the above were factual conclusions of the Tax Court essentially based upon a stipulated record. Guild was the only person to testify before the Tax Court. The answer to each of Guild's arguments is that the facts simply do not support his arguments, and unless the Tax Court's findings were clearly erroneous, its decision must be affirmed. *Commissioner v. Duberstein*; *Austin v. Commissioner*, and *Lamont v. Commissioner*, *supra* p. 11.

The question of whether Guild was fired for cause is not relevant to this proceeding. That was an issue which might have been resolved in the two lawsuits Guild brought

against Logan in 1965. The issue was not resolved since the latter suit was settled. Guild's argument that the settlement documents acknowledge his rights is unfounded both in fact and law<sup>11</sup>. Furthermore, whatever damages a New York State court might have given Guild had that case gone to judgment rather than been settled is wholly irrelevant in this proceeding.<sup>12</sup>

<sup>11</sup>In settlement of his suit against Logan, Guild was permitted to purchase 6,500 shares of Logan stock. That number of shares is unrelated to any claim Guild made or could have made. He might have had a "claim" to 5,000 shares—the portion of the option that would have come due before his employment contract terminated—or to 15,000 shares; but 6,500 shares obviously is a figure unrelated to his specific claims. Guild argues (Guild Br. pgs. 17-19) that the use of the term "recognize" in Logan's letter to him is a concession of the legitimacy of his claim or a legal admission of such claim. First, there was no testimony at the trial and there is no evidence in the record to support such an assertion. Second, it is common knowledge that lawsuits are often settled for reasons unrelated to the merits. Third, the definition Guild quotes from Webster's Third International Dictionary (Guild Br. p. 19a) is only one of approximately 20 definitions and subdefinitions given for that word. Fourth, the use of a word of such obvious general meaning cannot constitute an admission of any fact. Fifth, it has been forbidden as a matter of sound judicial policy, in the Supreme Court as well as in this Circuit, to permit the use of settlement documents or proposed settlements to establish liability in collateral suits, absent a clear, intended admission by a party. *West v. Smith*, 101 U. S. 263 (1879); *Seaboard Shipping Corp. v. Jocharanne Tugboat Corp.*, 461 F. 2d 500 at 505 (2nd Cir. 1972); *Hawthorne v. Eckersen Co.*, 77 F. 2d 844 (2nd Cir. 1935).

<sup>12</sup>Guild sought a sum certain in his alternative damage claims in both the federal and state court proceedings (R. 76a; 82a). In this Court Guild argues (Guild Br. p. 16) that money damages would not have been sufficient compensation for the loss of his option. His argument before this Court is completely inconsistent with his prior position. Guild also admitted in the state court proceedings that part of his claim related to an oral promise alleged to have been made by Logan's President (Stip. Ex. 8-H p. 13). Based upon these facts, it is understandable why the Tax Court, in rejecting Guild's claims that he was wrongfully discharged and that the settlement was concerned only with Guild's rights under the restricted stock option, could reach the conclusion: "Without commenting on the validity of this reasoning, we find that Guild has failed to establish the correctness of any of the assumptions upon which such reasoning is based" (R. 52a).

Even if a New York State court had required Logan to sell to Guild 15,000 shares of its stock at \$15.46 per share, that judgment could not characterize the sale as the exercise of a restricted stock option. This Court has often held that although state court judgments can obviously create rights between taxpayers, they cannot characterize those rights for federal income tax purposes. Such characterization is the function of the Internal Revenue Code and the authorities which construe that statute. *Estate of Borax v. Commissioner*, 349 F. 2d 666 (2nd Cir. 1965), *cert. denied* 383 U. S. 935 (1966) (state court decision that Mexican divorce invalid does not govern the deductibility of the husband's payments made pursuant to that divorce); *Miller v. Commissioner*, 299 F. 2d 706 (2nd Cir. 1962) (the creation of a property right under local law does not mean that "property" exists within the meaning of certain definitional sections of the Code); *Daine v. Commissioner*, 168 F. 2d 449 (2nd Cir. 1948) (state court's "order nunc pro tunc", although creating enforceable rights between the parties as of a prior date, cannot govern the tax consequences of the acts that occurred during the intervening period of time).

Guild did not "exercise" a restricted stock option when he met with Logan's President the day after his employment with Logan was terminated. Treasury Regulations Section 1.421-1(e)<sup>13</sup> defines the term exercise to mean "... the act of acceptance by the optionee of the offer to sell contained in the option. In general the time of exercise is the time when there is a sale or contract to sell between the corporation and the individual." Paragraph 6 of the option agreement required Guild to give written notice to purchase at the company's principal office in North Bergen, New

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<sup>13</sup>Treasury Regulations Section 1.421-1(e) is set forth in the addendum hereto.

Jersey. That paragraph required payment to the company in cash, certified check or bank cashier's check accompanied by a notice to the company that Guild was acquiring stock for investment purposes. Guild's oral demand did not meet these terms.

Wholly aside from the question of whether Guild had any present option under the terms of the written document, or whether the action of Logan's President might have constituted a rescission of the option, in order for an employee to exercise an option in these circumstances the employee's obligation to pay for and right to receive the stock must be absolute and unconditional. *Estate of James S. Ogsbury v. Commissioner*, 28 T. C. 93 (1957), *aff'd*, 258 F. 2d 294 (2nd Cir. 1958); *Edward C. Victorson v. Commissioner*, T. C. Memo 1962-231, *aff'd*, 326 F. 2d 264 (2nd Cir. 1964). The Tax Court's opinion in *Ogsbury* is directly on point. There, the Court was concerned with the question of whether a taxpayer could exercise an option in a year prior to his payment for the stock. The terms of the option expressly permitted deferred payment. In concluding that the taxpayer had exercised his option in the earlier year, the Court states:

"The language used in the contract is subject to only one interpretation—that petitioner and Fairchild entered into a binding agreement whereby petitioner's obligation to pay for and right to receive the stock became absolute and unconditional upon the mailing to Fairchild of the notice of petitioner's election to exercise the option. Petitioner could postpone payment within the limits set forth above, but could not rescind the contract thus made, nor refuse to pay for the stock when the limits of the postponement period had been reached." 28 T. C. at 99.

Guild's oral demand did not meet the express terms of the option and it did not unconditionally obligate him to take any action.

Guild argues (Guild Br. pgs. 25-30) that even if he had no option to exercise on November 10, 1964, and even if he did not exercise an option on that date, that the settlement of his suit against Logan constituted an acceleration of the remaining option privilege and thus retroactively gave him the rights that he did not have on November 10, 1964 under the terms of the agreement. There is no evidence in the Record to support such an argument. The Tax Court, in response to this argument, stated, "We do not agree. Logan contested Guild's right to purchase stock under the option from the day after his employment was terminated. Logan did nothing to accelerate Guild's rights under the option." (R. 50a). Guild fails to mention in his brief that, in addition to the letter written by Logan's President to Guild at the time of the settlement, Guild and Logan filed a Stipulation of Discontinuance in the state court action and executed mutual, unconditional releases to each other, releasing each other from any and all claims arising from their prior relationship (R. 89a-91a). None of these documents indicates an intent on Logan's part to accelerate Guild's option. Furthermore, Guild produced no testimony at the trial to support this claim even though Guild, himself, took the stand.

Guild recognizes (Guild Br. pgs. 25-30) when he argues that the settlement constituted an acceleration of the option that such an act might constitute a "modification" of the option. Normally if an option is modified it is viewed as the granting of a new option and thus must meet all of the requirements of a restricted stock option at the time of

modification. Treasury Regulations Section 1.421-4(b)(1). Guild's option clearly would not have met these requirements at any time after December 31, 1963 since options granted under the Logan option plan after December 31, 1963 could not meet the statutory requirements of Section 424(b).

Guild cites Section 425(h)(3)(C) of the Code for the proposition that a mere acceleration of the exercise date of an outstanding option will not be viewed as a modification. It is clear that Section 425(h)(3) of the Code stands for that proposition. It is also clear that Section 425(h)(3) of the Code applies to Qualified Stock Options granted under Section 422 of the Code and Employee Stock Purchase Plans governed by Section 423 of the Code. What Guild fails to point out is that the option involved in this case was granted prior to January 1, 1964, pursuant to the forerunner of Section 424 of the Code, and that in the view of the Internal Revenue Service, Treasury Regulations Sections 1.421-1 through 1.421-5 govern this option rather than Section 425(h)(3) of the Code. Treasury Regulations Section 1.421-1(g); see Prentice Hall Federal Taxes, Vol. 3, paragraph 19,401 (1976).

Treasury Regulations Section 1.421-4(c)(1) sets forth the opposite rule from that found in Section 425(h)(3)(C)<sup>14</sup>. Treasury Regulations Section 1.421-4(c)(1) states, "However, a change, which accelerates the time when the option is first exercisable, or which provides more favorable terms for the payment of the stock purchase under the option, is a modification." See *Rev. Rul. 63-227*, 1963-2 Cum. Bull. 192. At a minimum, therefore, even if it can be argued that Logan's settlement of Guild's lawsuit was intended to be an "acceleration" of Guild's

<sup>14</sup>Treasury Regulations Sections 1.421-1(g) and 1.421-4(c) are set forth in the addendum hereto.

option rights, it is not at all clear that Section 425 (h)(3)(C) of the Code has any applicability to the option involved in the instant case. Such an "acceleration" may have constituted a disqualifying modification of the option.

## POINT II

### **THE TAX COURT DID NOT ABUSE ITS DISCRETION IN DENYING GUILD'S POST-OPINION ATTEMPTS TO RAISE THE ISSUE OF THE MARKET VALUE OF THE LOGAN STOCK PURCHASED BY GUILD.**

Rule 91(e) of the Rules of Practice and Procedure of the United States Tax Court provides that a stipulation shall be treated to the extent of its terms as a conclusive admission by the parties to the stipulation. The Rule also provides that the court will not permit a party to a stipulation to qualify, change or contradict it, unless justice so requires. The parties to this consolidated case stipulated prior to the trial that the fair market value of the Logan stock on November 20, 1967, the date Guild purchased 6,500 shares of such stock in settlement of his lawsuit, was \$54.50 per share (R. 62a). On the basis of this stipulation the Tax Court found that the 6,500 shares purchased by Guild had a total fair market value of \$354,250 (R. 48a).

Rule 161 of the Rules of Practice and Procedure of the United States Tax Court<sup>15</sup> requires a motion for reconsideration to be filed within 30 days after the opinion has been served. The opinion in *Guild* was filed and served on September 16, 1974. Guild moved for reconsideration on February 19, 1975, approximately 150 days after the opinion was served, raising for the first time the issue of the value of the stock he purchased from Logan (R. 9a).

<sup>15</sup>Rule 91(e) and Rule 161 of the Rules of Practice and Procedure of the United States Tax Court are set forth in the addendum hereto.

The motion was denied on February 25, 1975 (R. 9a). This Court has long held the granting of such a motion by the Tax Court (or its forerunner, the Board of Tax Appeals) to be wholly within the Tax Court's discretion. *Weiller v. Commissioner*, 64 F. 2d 480 (2nd Cir. 1933), *aff'g*, 18 B. T. A. 1121 (1930). This Court has also held such discretion is not abused when the Tax Court fails to grant a motion which raises an entirely new theory; one not set forth by the parties in their pleadings. *Commissioner v. Sussman*, 102 F. 2d 919 (2nd Cir. 1939).

Guild is unable to argue that the Tax Court abused its discretion in denying his motion, and as the Commissioner aptly points out (Com. Br. pgs. 30-31), the authority upon which Guild relies had been in existence before the first pleadings in these cases were ever filed.

The only additional point to be added to the Commissioner's arguments on this issue relates to certain statements of what Guild perceives to be the law. Guild argues (Guild Br. p. 40) that it is clear as a matter of law that Securities Act investment representations have a significant effect on the value of the stock to which the representations relate. That is not a correct statement of the law. The Seventh Circuit in *M. P. Frank v. Commissioner*, 447 F. 2d 552 at 556 (7th Cir. 1971), *aff'g* 54 T. C. 75 (1970), rejected such a conclusion. A thorough reading of *Ira Hirsch v. Commissioner*, 51 T. C. 121 (1968), the case relied upon by the Internal Revenue Service in the portion of the Internal Revenue Manual quoted by Guild in his brief, (Guild Br. pgs. 38-39) demonstrates that the Tax Court considers it to be a question of fact whether such restrictions affect the value of a particular security. 51 T. C. at 134-136. Finally, the portion of the Internal Revenue Manual quoted by Guild, indicates that the Internal Revenue Service itself considers it to be a question of fact whether such restrictions affect the value of a particular security (Guild Br. p. 39).

**CONCLUSION**

The decisions of the Tax Court are correct and should be affirmed.

Respectfully submitted,

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**CERTIFICATE OF SERVICE**

It is hereby certified that service of this brief has been made on opposing counsel, by mailing four copies thereof to each on this *7th* day of January, 1976, in envelopes, with postage prepaid, properly addressed to each of them, respectively, as follows:

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**ADDENDUM**

**Internal Revenue Code of 1954 (26 U. S. C.):**

**SEC. 61. GROSS INCOME DEFINED.**

(a) **GENERAL DEFINITION.**—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

- (1) Compensation for services, including fees, commissions, and similar items;
- (2) Gross income derived from business;
- (3) Gains derived from dealings in property;
- (4) Interest;
- (5) Rents;
- (6) Royalties;
- (7) Dividends;
- (8) Alimony and separate maintenance payments;
- (9) Annuities;
- (10) Income from life insurance and endowment contracts;
- (11) Pensions;
- (12) Income from discharge of indebtedness;
- (13) Distributive share of partnership gross income;
- (14) Income in respect of a decedent; and
- (15) Income from an interest in an estate or trust.

SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) IN GENERAL.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

(2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

\* \* \*

SEC. 421. (As amended by Section 221(a), Revenue Act of 1964) GENERAL RULES.

(a) EFFECT OF QUALIFYING TRANSFER.—If a share of stock is transferred to an individual in a transfer in respect of which the requirements of section 422(a), 423(a), or 424(a) are met—

(1) except as provided in section 422(c)(1), no income shall result at the time of the transfer of such share to the individual upon his exercise of the option with respect to such share;

(2) no deduction under section 162 (relating to trade or business expenses) shall be allowable at any

time to the employer corporation, a parent or subsidiary corporation of such corporation, or a corporation issuing or assuming a stock option in a transaction to which section 425(a) applies, with respect to the share so transferred; and

(3) no amount other than the price paid under the option shall be considered as received by any of such corporations for the share so transferred.

(b) EFFECT OF DISQUALIFYING DISPOSITION.—If the transfer of a share of stock to an individual pursuant to his exercise of an option would otherwise meet the requirements of section 422(a), 423(a), or 424(a) except that there is a failure to meet any of the holding period requirements of section 422(a)(1), 423(a)(1), or 424(a)(1), then any increase in the income of such individual or deduction from the income of his employer corporation for the taxable year in which such exercise occurred attributable to such disposition, shall be treated as an increase in income or a deduction from income in the taxable year of such individual or of such employer corporation in which such disposition occurred.

\* \* \*

SEC. 424. (As amended by Section 221(a), Revenue Act of 1964) RESTRICTED STOCK OPTIONS.

(a) IN GENERAL.—Section 421(a) shall apply with respect to the transfer of a share of stock to an individual pursuant to his exercise after 1949 of a restricted stock option, if—

(1) no disposition of such share is made by him within 2 years from the date of the granting of the option nor within 6 months after the transfer of such share to him, and

(2) at the time he exercises such option—

(A) he is an employee of either the corporation granting such option, a parent or subsidiary corporation of such corporation, or a corporation or a parent or subsidiary corporation of such corporation issuing or assuming a stock option in a transaction to which section 425(a) applies, or

(B) he ceased to be an employee of such corporations within the 3-month period preceding the time of exercise.

(b) **RESTRICTED STOCK OPTION.**—For purposes of this part, the term “restricted stock option” means an option granted after February 26, 1945, and before January 1, 1964 (or, if it meets the requirements of subsection (c)(3), an option granted after December 31, 1963), to an individual, for any reason connected with his employment by a corporation, if granted by the employer corporation or its parent or subsidiary corporation, to purchase stock of any of such corporations, but only if—

(1) at the time such option is granted—

(A) the option price is at least 85 percent of the fair market value at such time of the stock subject to the option, or

(B) in the case of a variable price option, the option price (computed as if the option had been exercised when granted) is at least 85 percent of the fair market value of the stock at the time such option is granted;

(2) such option by its terms is not transferable by such individual otherwise than by will or the laws

of descent and distribution, and is exercisable, during his lifetime, only by him;

(3) such individual, at the time the option is granted, does not own stock possessing more than 10 percent of the total combined voting power of all classes of stock of the employer corporation or of its parent or subsidiary corporation. This paragraph shall not apply if at the time such option is granted the option price is at least 110 percent of the fair market value of the stock subject to the option, and such option either by its terms is not exercisable after the expiration of 5 years from the date such option is granted or is exercised within one year after August 16, 1954. For purposes of this paragraph, the provisions of section 425(d) shall apply in determining the stock ownership of an individual; and

(4) such option by its terms is not exercisable after the expiration of 10 years from the date such option is granted, if such option has been granted on or after June 22, 1954.

(c) SPECIAL RULES.—

(1) OPTIONS UNDER WHICH OPTION PRICE IS BETWEEN 85 PERCENT AND 95 PERCENT OF VALUE OF STOCK.—If no disposition of a share of stock acquired by an individual on his exercise after 1949 of a restricted stock option is made by him within 2 years from the date of the granting of the option nor within 6 months after the transfer of such share to him, but, at the time the restricted stock option was granted, the option price (computed under subsection (b)(1)) was less than 95 percent of the fair market value at such time of such share, then,

in the event of any disposition of such share by him or in the event of his death (whenever occurring) while owning such share, there shall be included as compensation (and not as gain upon the sale or exchange of a capital asset) in his gross income, for the taxable year in which falls the date of such disposition or for the taxable year closing with his death, whichever applies—

(A) in the case of a share of stock acquired under an option qualifying under subsection (b)(1)(A), an amount equal to the amount (if any) by which the option price is exceeded by the lesser of—

(i) the fair market value of the share at the time of such disposition or death, or

(ii) the fair market value of the share at the time the option was granted; or

(B) in the case of stock acquired under an option qualifying under subsection (b)(1)(B), an amount equal to the lesser of—

(i) the excess of the fair market value of the share at the time of such disposition or death over the price paid under the option, or

(ii) the excess of the fair market value of the share at the time the option was granted over the option price (computed as if the option had been exercised at such time).

In the case of a disposition of such share by the individual, the basis of the share in his hands at the time of such disposition shall be increased by an amount equal to the amount so includible in his gross income.

(2) VARIABLE PRICE OPTION.—For purposes of subsection (b)(1), the term “variable price option” means an option under which the purchase price of the stock is fixed or determinable under a formula in which the only variable is the fair market value of the stock at any time during a period of 6 months which includes the time the option is exercised; except that in the case of options granted after September 30, 1958, such term does not include any such option in which such formula provides for determining such price by reference to the fair market value of the stock at any time before the option is exercised if such value may be greater than the average fair market value of the stock during the calendar month in which the option is exercised.

(3) CERTAIN OPTIONS GRANTED AFTER DECEMBER 31, 1963.—For purposes of subsection (b), an option granted after December 31, 1963, meets the requirements of this paragraph if granted pursuant to—

(A) a binding written contract entered into before January 1, 1964, or

(B) a written plan adopted and approved before January 1, 1964, which (as of January 1, 1964, and as of the date of the granting of the option)—

(i) met the requirements of paragraphs (4) and (5) of section 423(b), or

(ii) was being administered in a way which did not discriminate in favor of officers, persons whose principal duties consist of supervising the work of other employees, or highly compensated employees.

SEC. 425. (As amended by Section 221(a), Revenue Act of 1964) DEFINITIONS AND SPECIAL RULES.

\* \* \*

(h) MODIFICATION, EXTENSION, OR RENEWAL OF OPTION.—

(1) IN GENERAL.—For purposes of this part, if the terms of any option to purchase stock are modified, extended, or renewed, such modification, extension, or renewal shall be considered as the granting of a new option.

(2) SPECIAL RULES FOR SECTIONS 423 AND 424 OPTIONS.—

(A) In the case of the transfer of stock pursuant to the exercise of an option to which section 423 or 424 applies and which has been so modified, extended, or renewed, then, except as provided in subparagraph (B), the fair market value of such stock at the time of the granting of such option shall be considered as whichever of the following is the highest:

(i) the fair market value of such stock on the date of the original granting of the option,

(ii) the fair market value of such stock on the date of the making of such modification, extension, or renewal, or

(iii) the fair market value of such stock at the time of the making of any intervening modification, extension, or renewal.

(B) Subparagraph (A) shall not apply with respect to a modification, extension, or renewal

of a restricted stock option before January 1, 1964 (or after December 31, 1963, if made pursuant to a binding written contract entered into before January 1, 1964), if the aggregate of the monthly average fair market values of the stock subject to the option for the 12 consecutive calendar months before the date of the modification, extension, or renewal, divided by 12, is an amount less than 80 percent of the fair market value of such stock on the date of the original granting of the option or the date of the making of any intervening modification, extension, or renewal, whichever is the highest.

(3) DEFINITION OF MODIFICATION.—The term “modification” means any change in the terms of the option which gives the employee additional benefits under the option, but such term shall not include a change in the terms of the option—

(A) attributable to the issuance or assumption of an option under subsection (a);

(B) to permit the option to qualify under sections 422(b)(6), 423(b)(9), and 424(b)(2); or

(C) in the case of an option not immediately exercisable in full, to accelerate the time at which the option may be exercised.

If a restricted stock option is exercisable after the expiration of 10 years from the date such option is granted, subparagraph (B) shall not apply unless the terms of the option are also changed to make it not exercisable after the expiration of such period.

**Treasury Regulations in Income Tax (1954 Code) (26 C. F. R.):**

**1.61-2 COMPENSATION FOR SERVICES, INCLUDING FEES, COMMISSIONS, AND SIMILAR ITEMS.**

\* \* \*

(d) *Compensation paid other than in cash*—(1) *In general.* If services are paid for other than in money, the fair market value of the property or services taken in payment must be included in income. If the services were rendered at a stipulated price, such price will be presumed to be the fair market value of the compensation received in the absence of evidence to the contrary. However, for special rules relating to certain options received as compensation, see § 1.61-15 and section 421 and the regulations thereunder.

(2)(i) *Property transferred to employee or independent contractor.* Except as otherwise provided in section 421 and the regulations thereunder (relating to employee stock options) and § 1.61-15, if property is transferred by an employer to an employee, or if property is transferred to an independent contractor, as compensation for services for an amount less than its fair market value, then regardless of whether the transfer is in the form of a sale or exchange, the difference between the amount paid for the property and the amount of its fair market value at the time of the transfer is compensation and shall be included in the gross income of the employee or independent contractor. In computing the gain or loss from the subsequent sale of such property, its basis shall be the amount paid for the property increased by the amount of such difference included in gross income.

## 1.162-9 BONUSES TO EMPLOYEES.

Bonuses to employees will constitute allowable deductions from gross income when such payments are made in good faith and as additional compensation for the services actually rendered by the employees, provided such payments, when added to the stipulated salaries, do not exceed a reasonable compensation for the services rendered. It is immaterial whether such bonuses are paid in cash or in kind or partly in cash and partly in kind. Donations made to employees and others, which do not have in them the element of compensation or which are in excess of reasonable compensation for services, are not deductible from gross income.

## 1.421-1 EFFECTIVE DATES AND MEANING AND USE OF CERTAIN TERMS.

\* \* \*

(e) *Exercise.* For the purpose of section 421, the term "exercise," when used in reference to an option, means the act of acceptance by the optionee of the offer to sell contained in the option. In general, the time of exercise is the time when there is a sale or a contract to sell between the corporation and the individual. An agreement or undertaking by the employee to make payments under a stock purchase plan does not constitute the exercise of an option so long as the payments made remain subject to withdrawal by the employee.

\* \* \*

(g) *Effective dates.* Sections 1.421-1 through 1.421-5 are applicable only to options granted after February 26, 1945, and before January 1, 1964, and all references therein to sections of the Code are to the Internal Revenue Code of 1954, before the amendments made by sec-

tion 221 of the Revenue Act of 1964 (78 Stat. 63). Section 1.421-6 is applicable only to options granted on or after February 26, 1945, and all references to sections of the Code are to the Internal Revenue Code of 1954, as amended. Sections 1.421-7 and 1.421-8 are applicable only to options granted after December 31, 1963, and all references therein to sections of the Code are to the Internal Revenue Code of 1954, as amended.

#### 1.421-4 MODIFICATION, EXTENSION, OR RENEWAL.

\* \* \*

##### (c) *Definition of modification, extension, or renewal.*

(1) The time or date when an option is modified, extended, or renewed shall be determined, insofar as applicable, in accordance with the rules governing determination of the time or date of granting an option provided in § 1.421-1(b). For the purpose of section 421, the term "modification" means any change in the terms of the option which gives the optionee additional benefits under the option. For example, a change in the terms of the option, which shortens the period during which the option is exercisable, is not a modification. However, a change, which accelerates the time when the option is first exercisable, or which provides more favorable terms for the payment for the stock purchased under the option, is a modification. A mere change in the terms of the option, with respect to the number or price of the shares of stock subject to the option, to reflect a stock dividend or stock split-up is not a modification of the option. In case there is an assumption or substitution of the option by reason of certain corporate transactions, see paragraph (d) of this section. Where an option is amended solely to increase the number of shares subject to the option, such increase

shall not be considered as a modification of the option, but shall be treated as the grant of a new option for the additional shares.

\* \* \*

**Rules of Practice and Procedure of the United States Tax Court:**

**Rule 91. STIPULATIONS FOR TRIAL.**

\* \* \*

(e) *Binding Effect.* A stipulation shall be treated, to the extent of its terms, as a conclusive admission by the parties to the stipulation, unless otherwise permitted by the Court or agreed upon by those parties. The Court will not permit a party to a stipulation to qualify, change, or contradict a stipulation in whole or in part, except that it may do so where justice requires. A stipulation and the admissions therein shall be binding and have effect only in the pending case and not for any other purpose, and cannot be used against any of the parties thereto in any other case or proceeding.

\* \* \*

**Rule 161. MOTION FOR RECONSIDERATION OF FINDINGS OR OPINION.**

Any motion for reconsideration of an opinion or findings of fact, with or without a new or further trial, shall be filed within 30 days after the opinion has been served, unless the Court shall otherwise permit.